

Coming soon: A legal definition of virtual currencies

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It has been known for some time that the European Commission plans to extend the EU's regulations on anti-money laundering and combating of terrorism financing (AML/CTF) to cover digital currencies. In February 2016 the Commission announced that it would present a proposal for changes in law in this area by the middle of the year.

The legislative proposal was presented in July 2016. It may bring about many changes for individuals and firms operating in the area of digital currencies, and perhaps also for those involved in distributed ledger (blockchain) technology.

Goal of proposal

The plan to adopt regulations governing digital currencies is part of a broader project. Its main goal is more effective combating of financing of terrorism. Other elements of the project include introduction of restrictions on certain prepaid instruments (such as prepaid cards) and vesting new authority in financial intelligence units, i.e. state agencies responsible for AML/CTF operations—in Poland, the General Inspector of Financial Information (GIIF).

The main purpose of the proposal is to fill the gap in oversight of funds used by terrorists. Additionally, the proposal is designed to increase the transparency of financial transactions.

The Commission determined that suspicious transactions carried out using digital currencies are not being adequately monitored. Consequently, the competent public authorities are not in a position to link transactions to specific, identified persons. The new regulations are intended to counter these difficulties and reduce the degree of anonymity of users of digital currencies.

Commission proposal

The Commission analysed six regulatory variants. Finally it selected the option that would amend the EU's 4th Anti-Money Laundering Directive (4AMLD) to cover digital currency exchange platforms (such as exchanges) and certain custodial wallet providers. It is not ruled out that additional measures will be adopted involving a system of voluntary self-identification of digital currency users.

The proposal thus calls for recognition of exchanges and certain custodial wallet providers as being subject to the requirements of 4AMLD (referred to in the Polish AML/CTF Act as "obligated institutions").

In practice this means that these entities would become subject to numerous obligations set forth in 4AMLD and the Polish act. These duties include identification of customers and reporting of transactions. So far, despite numerous doubts, this has not been the case, as we reported last year in the article "[Bitcoin and money-laundering regulations.](#)" Notably, however, some exchanges already comply with some of these obligations voluntarily.

Definition of virtual currencies

In order to implement these measures, the Commission has proposed introduction of a definition of "virtual currencies" to mean "a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically."

On one hand this definition is quite broad, as it covers the indefinite category of "digital representation of value." At the same time it is technologically neutral, because it does not indicate that it covers only currencies based on a specific technology such as blockchain. One may even wonder if it could be broad enough to cover "bank money."

On the other hand, the definition seems both narrow and vague. One of the grounds for recognition of a virtual currency is that it is "accepted by natural or legal persons as a means of payment." While this condition is clearly met by Bitcoin, it is not clear whether it would apply, for example, to Ether (the "crypto-fuel" of the Ethereum network, which generally does not serve a payment function as typically understood), not to mention new tokens appearing every day in various blockchains. Any issuer of a new token would need to keep this definition in mind.

In a certain sense, this definition is of a technical nature, as it would be used primarily to determine the entities that would be covered by the directive. Nonetheless, it might exert far-reaching influence in practice.

If the Commission's proposal is adopted, this definition will have to be implemented into the legal systems of all the member states. In most of the member states, including Poland, it would be the first legal definition of "virtual currencies" ever. Though it is proposed for the purposes of 4AMLD, it would surely reverberate across other fields of law. As of now, any public authority confronting the issue of virtual currencies can

follow its own definition. In the future, the European Commission's proposed definition will serve at the least as a touchstone for any legal analysis concerning digital currencies.

Other options considered by the Commission

Before presenting this proposal, the Commission conducted a number of studies in which other regulatory options were considered. The Commission concluded that its principal goal of reducing or eliminating the anonymity of users of digital currencies could be achieved by enacting measures targeting three groups of entities. On this basis six possible options were outlined:

Targeting users

Option A—mandatory registration of users

Option B—voluntary self-registration of users

Targeting exchange platforms

Option C—regulation of exchange platforms under 4AMLD

Option D—regulation of exchange platforms under the revised Payment Services Directive (PSD2)

Targeting custodial wallet providers

Option E—regulation of custodial wallet providers under 4AMLD

Option F—regulation of custodial wallet providers under PSD2.

Finally the Commission decided to propose adoption of options C and E, as well as potentially option B. Interestingly, all member states but one supported option C, and not option D. Option D would have resulted in imposing numerous more stringent regulations on exchange platforms. But it cannot be ruled out that options that have been rejected for now may be revisited again in the future.

Will the adopted solutions be effective?

The core of the proposal, expanding the EU's AML/CTF regulations to cover digital currencies, appears well-justified and comes as no surprise. In some other jurisdictions comparable regulations have already been introduced.

It is not certain, however, how the new regulations would impact the further development of innovations based on blockchain technology. The first historic application of this technology is Bitcoin and other cryptocurrencies, and they are the targets of the Commission's proposal. New applications of blockchain technology are arising, typically having as one element some kind of digital token which does not function as a currency but nonetheless could be deemed to be a "virtual currency" under the definition cited above. It appears that the future practice of applying these regulations should address and resolve these doubts, adjusting the new regulations accordingly.

Next steps

Interestingly, the Commission's proposal involves amending 4AMLD, adopted at the EU level only in May 2015 and not required to be implemented by the member states until June 2017.

The Commission's proposal calls for moving forward the implementation of 4AMLD to 1 January 2017. Thus if the proposal is adopted the Polish AML/CTF Act would need to be amended in this regard by the end of 2016.

For now the Commission proposal will be undergoing legislative work at the EU level, and during the course of the legislative process it may be subject to revision.

